RD AN No. 4171 (1980-D)
April 13, 2006

TO: All State Directors
Rural Development

ATTENTION: Rural Housing Program Directors,
Guaranteed Rural Housing Specialists,
Rural Development Managers, and
Community Development Managers

FROM: Russell T. Davis ***(Signed by James C. Alsop) for***
Administrator
Housing and Community Facilities Programs

SUBJECT: Utilizing Credit Scores for Underwriting Single Family Housing Guaranteed Loans

PURPOSE/INTENDED OUTCOME:

This Administrative Notice (AN) outlines two uses for Fair Isaacs & Company (FICO) credit scores when underwriting Single Family Housing Guaranteed Loan Program (SFHGLP) loans. The purpose of this AN is to make use of credit scoring technologies to improve the credit quality of SFHGLP loans, and to streamline SFHGLP credit history documentation requirements.

COMPARISON WITH PREVIOUS AN:

This AN replaces AN No. 4067 (1980-D) dated April 1, 2005. This AN differs from the previous one by addressing the introduction of a new credit score that combines information from the three major credit reporting repositories.

EXPIRATION DATE:
April 30, 2007

FILING INSTRUCTIONS:
Preceding RD Instruction 1980-D

BACKGROUND:

The three major credit reporting repositories, Equifax, Experian, and Trans Union, recently introduced a new credit scoring model trademarked as VantageScore. Rather than producing a different credit score from each credit reporting repository, VantageScore is marketed as incorporating information from all three repositories to arrive at a single score. The VantageScore range is from 501 to 990, with higher scores representing a lower likelihood of risk.

Currently, the great majority of mortgage lenders continue to use FICO scores. Most automated underwriting systems are built to use FICO scores, and reconfiguring them will take time and money. Industry participants, including the Federal Housing Administration (FHA), Veteran Affairs (VA), Fannie Mae, and Freddie Mac, do not accept VantageScore at this time. Once Rural Development and the mortgage industry have had time to evaluate the new score, further guidance will be issued. At this time, VantageScore is not accepted for SFHGLP loans.

Since the early 1990's, the mortgage industry has employed FICO and other credit scoring models for risk evaluation purposes and to streamline documentation requirements for applicants whose credit scores imply less credit risk. Fannie Mae and Freddie Mac have encouraged the use of credit scores by lenders and have developed their own automated underwriting systems that evaluate risk. Increasingly throughout the 1990's and early 2000's, the residential mortgage market, including FHA and VA, have utilized credit score based technology as the basis for credit extension decisions. Rural Development can benefit by employing the use of credit scores, as well. By incorporating credit scores into the loan underwriting process, Rural Development can both improve the efficiency of its program, and help ensure that SFHGLP loans are made to applicants with credit histories indicating a reasonable probability of successful homeownership.

The primary starting point for many automated mortgage loan origination systems has been the statistical analysis and scoring models developed by FICO, widely known as FICO credit scores. FICO scores are used for many types of lending decisions, and they are an important component of most automated mortgage loan origination systems. A FICO credit score is based exclusively on data in a credit report. Factors never considered in a credit report or credit score include gender, race, age, national origin, religion, income level, or marital status. When a FICO score is calculated, the applicant's credit report information is measured against historical data from thousands of loan profiles and their respective loan repayment performances. The applicant is then assigned a "score" predicting loan performance should credit be extended. FICO scores have been found to be highly predictive. Home mortgage industry statistics, as well as a study of SFHGLP loans by the National Office, indicate that borrowers with FICO scores over 660 historically experience far less defaults than borrowers with FICO scores under 660. Borrowers with FICO scores under 660 statistically experience rates of defaults high enough to warrant a thorough evaluation prior to extending mortgage credit.

Rural Development has been tracking and studying FICO scores for loans originated under the SFHGLP. Random samplings of current and delinquent loans indicate that FICO scores have a great deal of predictive value concerning loan performance. The following FICO range descriptions have become an accepted standard in the mortgage industry:

<u>FICO Scores of 720 and above</u>. The risk of default is statistically very low for applicants with credit scores in this range. Scores in this range are considered to represent excellent credit histories. Underwriters may judge the applicant's credit history to be very favorable. Much less emphasis can be placed on the role of repayment ratios in determining an applicant's creditworthiness. If there was additional credit history information of significance, which was not included in the credit repository's file (and therefore, not taken into consideration in the credit score), an underwriter typically should use his or her judgment to determine the effect of that information on the applicant's creditworthiness. Because of the strength of the score, the underwriter need not obtain documentation from the applicant to explain instances of derogatory credit or recent credit inquiries.

<u>FICO Scores Between 660 and 719</u>. The risk of default is low for applicants who have credit scores in this range. Applicants with scores in this range are considered to have good credit histories that represent an acceptable level of risk to lenders and secondary markets. As long as the underwriter determines that no significant credit information is missing from the repository's credit file, he or she typically should consider the applicant's credit history to be acceptable without performing any additional analysis. Less emphasis can be placed on the role of repayment ratios in determining an applicant's creditworthiness. Because of the strength of the applicant's credit score, the underwriter usually should not have to obtain documentation to explain instances of derogatory credit or recent credit inquiries.

<u>FICO Scores between 620 and 659</u>. From a statistical perspective, applicants who have credit scores in this range begin to represent a higher degree of default risk. The credit score alone, however, is not sufficient for the underwriter to make an informed decision about the acceptability of the applicant's credit history. Before approving financing for an applicant who has a credit score in this range, the underwriter typically should perform a complete assessment of all aspects of the applicant's credit history. The underwriter should consider the applicant's credit history risk in relation to other risks in the application to form an opinion about overall mortgage risk. The underwriter should generally consider an applicant with a credit score in this range acceptable as long as multiple high-risk factors (such as applicants who have recently become self-employed, payment shock, or applicants who have debt-to-income ratios in excess of benchmark ratios) are not layered.

<u>FICO Scores Below 620</u>. The risk of default is statistically very high for applicants who have credit scores in this range. Although these applicants account for a relatively small percentage of the total population of potential borrowers who have credit histories on file at one of the major credit repositories, research shows that they account for a disproportionate percentage of the eventual defaults. Because of the high risk of default associated with scores below 620, the underwriter should apply good judgment when he or she considers the unique circumstances of each application. The underwriter should look for compensating factors that were not considered

in the development of the credit score or extenuating circumstances that can offset the credit risk reflected by the poor credit history. If there are sufficient compensating factors or extenuating circumstances that offset the higher risk of default associated with credit scores in this range, the underwriter may approve the financing. When the credit score is in this range, the underwriter should approve the mortgage application only if there is very little or no risk layering and strong compensating factors or extenuating circumstances are present to offset the applicant's high-risk credit history record. However, the FICO score should not be the sole determining factor in reaching an underwriting decision. Although a low credit score is indicative of a higher risk of default, it may still be appropriate to approve an applicant who has a low credit score based on other factors present in the mortgage application.

IMPLEMENTATION RESPONSIBILITIES:

FICO scores may be used to reduce or streamline documentation requirements for SFHGLP applicants with FICO scores of 660 or higher. In addition, to ensure they present an acceptable level of credit risk, lenders should judiciously evaluate applicants with FICO scores under 660, paying particular attention to carefully screening the credit histories of those applicants with FICO scores below 620.

FICO scores are also known as Beacon scores, Empirica scores, and Fair Issac scores, and one or more scores can be found listed on a borrower's credit report. If the borrower's credit report contains two scores, the lower of the two should be used for purposes of this AN. If the borrower has three scores, the middle score should be used as the representative score. Similar treatment should be given a co-borrowers credit score. If there is more than one applicant, the credit score of the primary wage-earner should be the one given the most emphasis. This does not mean that the FICO credit scores for other applicants should be ignored.

FICO scores generally range between 300 and 900. If no score is available the credit bureau output will be zero. Zero in these cases has the literal meaning of null, or indicating there were not enough information or credit references for the statistical model to compute a credit score value.

Streamlined Documentation when the FICO Credit Score is 660 or Higher

SFHGLP applicants with FICO scores of 660 or above may take advantage of the streamlined documentation requirements listed below, unless there are co-applicants with FICO scores under 620, in which case this streamlined process will not apply.

- A lender shall not be required to document adverse credit history waivers under RD Instruction 1980-D, section 1980.345(d)(3), except for those involving a delinquent Federal debt or previous Agency loan.

- A lender shall not be required to document applicant rent payment history. If the applicant's FICO score is under 660 and the applicant has a rent payment history, the lender should obtain a rent payment reference either as part of the credit report or separately. In such cases, the lender should obtain verification of the applicant's rent payment history for the 12 month period prior to the loan application.

- No action will be necessary for any derogatory items, such as those listed in RD Instruction 1980-D, section 1980.345(d)(1), contained on the credit history except for those involving a delinquent Federal debt or previous Agency loan. For example, if the credit report indicates there have been incidents of more than one debt payment being more than 30 days late within the last 12 months, those incidents will not be investigated and considered evidence of an inadequate credit history if the FICO score is at least 660. As another example, if there is a non-Federal collection account outstanding, it too need not be investigated or considered, and there will be no requirement that evidence be furnished showing the collection account has been resolved or that arrangements for repayment have been made.

Applicants with FICO Credit Scores Between 620 and 659

When the FICO score falls between 620 and 659, the credit score alone is not sufficient for the underwriter to make an informed decision concerning credit history, and a full assessment of all aspects of the applicant's credit history is required. The lender should perform a complete underwriting analysis of the SFHGLP loan to ensure eligibility based on RD Instruction 1980-D requirements. Any credit history waiver granted should be addressed by the underwriter and supported by plausible documentation in the loan file in accordance with RD Instruction 1980-D, section 1980.345(d)(3). The underwriter should make certain that multiple high risk factors are not layered.

Applicants with FICO Credit Scores Under 620

A FICO score under 620 means that the applicant would statistically have a high likelihood of default on their loan, and that there are likely to be adverse credit history issues that will have to be addressed in the underwriting analysis. It ***does not mean*** that every applicant with a FICO score under 620 is a poor credit risk and should be rejected. There are applicants with FICO scores under 620 that will pay their loans as agreed.

Applicants with credit scores under 620 should be carefully reviewed during the lender's underwriting analysis. Layered risk associated with the application, such as ratio waivers or credit history waivers, should be avoided unless strong supporting documentation substantiating the waiver exists. If an applicant is being considered for an adverse credit history waiver, a debt ratio waiver, or has questionable repayment income or job stability, the loan record must contain sufficient justification by the underwriter for approving the loan. The analysis should include an assessment of any compensating factors, or credit history explanations that establish the applicant's ability and willingness to repay the proposed loan as agreed. If the lender grants an adverse credit waiver, the lender must secure documentation evidencing that the circumstances surrounding the adverse information were temporary in nature, and were beyond the applicant's control, and have been removed so their reoccurrence is unlikely. Alternately, the lender must secure documentation evidencing that the delinquency arose from a justifiable dispute related to defective goods or services.

SUMMARY:

FICO credit scores are an indicator of credit risk, and can be very effectively used as a tool for credit risk management. Credit scores help underwriters understand the strength of an applicant's credit history and can help to identify those applicants that may require careful underwriting attention. However, FICO scores should never be used in isolation or as the sole basis for a SFHGLP loan underwriting decision. SFHGLP loan applications that are rejected by lenders based on underwriting risk should be rejected based on underwriting criteria established in RD Instruction 1980-D, such as lack of repayment ability, lack of adequate and dependably available income, inadequate credit history, or collateral that does not meet the required standards.

Lender Monitoring

On an ongoing basis, Agency field staff should monitor originating lenders for adherence to SFHGLP loan underwriting requirements, including the standards outlined in this AN. Field staff conducting lender origination monitoring reviews should pay special attention to credit scores when reviewing first year delinquencies and early defaults. For portfolio monitoring purposes, credit scores will be captured in the future for all SFHGLP loans.

Should there be any comments or questions concerning this AN, please contact Joaquín Tremols or Dave Chaput at (202) 720-1452. Their respective email addresses are joaquin.tremols@wdc.usda.gov and david.chaput@wdc.usda.gov .